

## National Rural Utilities Cooperative Finance Cooperation: Major Statutory Points

This is to summarize the best statutory reasons for CFTC to issue final rules to clarify that the transactions by the nonprofit National Rural Utilities Cooperative Finance Corporation (CFC) should be exempted in final regulations from clearing and margin requirements. CFC comments filed with the CFTC and other agencies make clear that our transactions – on average CFC executes 15 a year – should be transparent and reported. We would welcome CFTC rules that require the CFC to provide detailed financial reports and information about our transactions on behalf of our member-owners, the rural electric cooperatives.

CFC is wholly owned and controlled by its nonprofit rural cooperative owners. Congress highlighted CFC's nonprofit owners for special treatment in section 722(f) of the Dodd-Frank Act (DFA) because, in part, those rural electric cooperatives act in the public interest under federal law and CFC has no existence or purpose outside of serving the rural electric cooperatives and has no leeway or authority to speculate, ever.

It is not just the absolutely clear, and directly on point, legislative history of DFA that supports the above statement,<sup>1</sup> the text of the DFA highlights that special treatment should be considered for the nonprofit, public purpose, rural electric cooperatives by both the CFTC and the SEC.

Section 4(c) of the Commodity Exchange Act includes a specific statutory reference that the transactions between entities described in section 201(f) of the Federal Power Act (16 U.S.C. 824(f)) – which entities include the nonprofit CFC and their owners the nonprofit rural electric cooperatives – shall be exempted by the CFTC and the SEC from the clearing requirements set forth in section 4(a) “[i]f the Commission determines that the exemption would be consistent with the public interest and the purposes of this Act . . .” The text of the Federal Power Act subsection 201(f) makes clear that entities wholly owned by the public purpose rural electric cooperatives should be treated in the same manner as those cooperatives.<sup>2</sup>

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<sup>1</sup> A letter signed by the Chairs of the two Senate Committees that authored for the Senate the Dodd-Frank Act – Chairmen Dodd and Lincoln – states that the “consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to **protect end users from burdensome costs associated with margin requirements and mandatory clearing.**” Indeed, a more recent letter from Senate Chairmen Stabenow and Johnson and House Chairmen Lucas and Bachus restated their “continued support for the comments expressed” in that June 30 Dodd-Lincoln letter which further noted that:

Congress . . . created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. Those entities could [include] . . . energy companies who produce and distribute power. . . . **They also include captive finance affiliates, finance arms that are hedging . . .** That is why Congress provided regulators the authority to exempt these institutions.”

<sup>2</sup> That Federal Power Act reference covers, in part, “an electric cooperative that receives financing under the Rural Electrification Act of 1936 (7 U.S.C. 901 *et seq.*) . . . or any agency, authority, or instrumentality of any one or more of the foregoing, **or any corporation which is wholly owned**, directly or indirectly, by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty. . . .” (Emphasis added.)

The CFTC in its own rulemakings discussed this “public interest” issue when it provided additional guidance on the scope of this statutory exemption in its “Further Definitions” proposal.

The CFTC recognized that “some electricity services are provided as a public good rather than for profit” and referred to the Federal Power Act and to the “non-profit, public power systems such as rural electric cooperatives.”<sup>3</sup> That preamble invited comments on “whether there are special considerations, *including without limitation special considerations* arising from section 201(f) of the Federal Power Act, related to *non-profit, public power systems such as rural electric cooperatives* . . . .”<sup>4</sup> (emphasis added.)

Since the CFC is “directly,” and “wholly owned” by the cooperatives, it should be accorded, at a minimum, the status of a legally, totally controlled, affiliate. The text of the Federal Power Act reference, discussed above, specifically covers “**any corporation which is wholly owned**” by the rural cooperatives. Our June 3 filing (RIN 3038-AD10, End User Reopened) and RIN 30388-AD06, 3235-AK65, “Definitions Reopened”) fully explains our arguments.

The DFA also provides that an “affiliate of a person that qualifies for [the end user exception] may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.”

As noted in the proposed rule, the CFTC has leeway in how it chooses to define “affiliate.” We encourage the CFTC to choose to define this term, and to write the regulation implementing this provision of DFA, in a manner so as to allow activities such as CFC’s to come under the affiliate exception. CFC’s members qualify for the end-user exception. CFC’s use of derivatives is done “on behalf of” its members because (1) those members own CFC and CFC exists only to serve its members; and (2) CFC’s goal in using derivatives is to manage risks for all CFC members while allowing each individual member to obtain financing on terms it prefers.

Since our members are in the business of producing and distributing electricity, and not managing a derivative portfolio, CFC enters into derivatives contracts itself, since it has the professional expertise, credit rating, accounting functions, and banking relationships necessary to do so.

That is why CFC should not be considered a “financial entity” which we explain in much greater detail in our filings.<sup>5</sup> In short, the DFA definition of “financial entity” includes entities “predominantly engaged in activities that are in the business of banking, or financial in nature, as defined in Section 4(k) of the Bank Holding Company Act.” While such activities include lending, CFC does not engage in the business of lending in a manner akin to the way depository institutions engage in the business of lending, or in other activities in the business of banking. For instance, while banks engage in lending to the public in order to make a profit, CFC is a

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<sup>3</sup> 75 FR 80184 (Dec. 21, 2010).

<sup>4</sup> See 75 FR 80184 (referencing the “exemptive authority in section 722(f) of the Dodd-Frank Act. . .”).

<sup>5</sup> “Further Definitions . . . .” RIN 3038-AD-06, due Feb. 22, 2011; “End-User Exception,” RIN 3038-AD10; and in the “CFC Comments on Reopened Comment Periods,” dated June 3, 2011, on those proposals.

nonprofit cooperative that lends only to its nonprofit members -- in a sense it lends to itself -- and exists to serve its members rather than the general public.

In addition, we have filed detailed comments<sup>6</sup> explaining how the “parent company” exception applies to the CFC since more than 90% of its business consists of providing financing to its rural electric system member-owners and their related organizations so they can deliver a product – electricity. CFC has many parents (our rural cooperative owners) and CFC’s use of derivatives arises from the financing of facilities needed to create and deliver a product -- electricity -- for rural America.

CFC is required to, and does, operate solely in the public interest on behalf of its cooperative owners to reduce their costs and mitigate risks. CFC was created by those cooperatives to provide them with internal access to non-governmental market capital.

This model of one centralized, internal (captive) entity worked especially well during the financial crisis in 2008. Indeed, the electric distribution cooperatives announced on July 31, 2009, “strong financial results during the economic downturn” of 2008. Surely, there are more pressing entities and problems on which the CFTC and the SEC should focus its resources and time.

The extent of financial problems faced by the nation as the Congress crafted the DFA are described in its legislative history, hundreds of press reports, books, and articles, and in the Financial Crisis Inquiry Report (including the dissenting views).<sup>7</sup> The focus during the financial crisis was certainly never on nonprofit cooperatives such as CFC, which is owned by, and created to serve, nonprofit rural electric cooperatives and their “public interest” goals as that phrase is used in the DFA.

We have attached a separate document – Attachment 1 – which includes rule changes previously recommended by CFC. For a full explanation of the basis for the CFC-recommended changes, please see the texts of those comment letters already filed with the CFTC (or other agencies).

### **Attachment 1**

#### **National Rural Utilities Cooperative Finance Cooperation: Major Statutory Points**

This document contains recommendations already filed with the CFTC by the National Rural Utilities Cooperative Finance Corporation (CFC) for regulatory changes regarding implementation of the Dodd-Frank Act.

This document includes recommended rule changes, to date, but does not include the detailed justifications found in the CFC comment letters. This document includes only short summaries of those justifications.

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<sup>6</sup> Cited in note 5.

<sup>7</sup> “The Financial Crisis Inquiry Report,” issued by Financial Crisis Inquiry Commission, Jan. 2011.

**1. CFC does not resemble other “financial entities” clearly meant to be covered by the statutory definition.** CFC’s activities can be distinguished from those of such institutions, which are engaged in the business of banking and/or other financial activities. CFC is a nonprofit entity and is not focused on making profits or lending to the public. For example, it makes loans to its owners – the nonprofit rural cooperatives. It is a nonprofit entity created for a public purpose, acting as the financing arm of its member rural electric cooperatives (RECs). As we noted in our earlier information submitted to the CFTC, neither CFC nor its REC owners engage in any speculative trading. The electric power cooperatives reported strong financial results during the economic crisis, in part, because their major product is electricity – which is an essential service.

Unlike other corporations or cooperatives, a section of the Dodd-Frank Act (as mentioned in the above analysis) specifically references, as do CFTC rule proposals, the rural electric cooperatives and the entities which they own (which would include CFC) as candidates for an exemption from Dodd-Frank requirements. *See* sections 722(f) of DFA and 201(f) of the Federal Power Act (16 U.S.C. 824(f)) and the comment in CFTC’s “Further Definitions . . . ,” proposal on “including without limitation special considerations arising from section 201(f) of the Federal Power Act, related to non-profit, public power systems such as rural electric cooperatives . . .” and the entities they own.

We suggest final regulatory language such as the following to clarify the definition of “financial entity”:

- **“‘Financial entity’ does not include: a nonprofit tax-exempt cooperative that is not a depository institution and a majority of whose members are nonprofit tax-exempt cooperatives that are not financial entities.”**
- **“Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose.”**

**2. CFC should qualify for the end-user clearing exception as an affiliate of end users.** DFA provides an affiliate exception to the “financial entity” definition that could apply to CFC. Under the affiliate exception, “An affiliate of a person that qualifies for [the end-user exception] may qualify for the exception only if the affiliate, acting on behalf of the person and as an agent, uses the swap to hedge or mitigate the commercial risk of the person or other affiliate of the person that is not a financial entity.”

CFC enters into swaps *for the benefit of its member-owners*, which we believe fits in well with the motivation behind the affiliate exception.

CFC uses swaps to hedge risk that arises from lending to its members, which own CFC and control CFC on a “one member, one vote” basis, and thus should be characterized as affiliates of CFC.

CFC’s use of derivatives is done on behalf of its members because (1) those members own CFC and CFC exists only to serve its members; and (2) CFC’s goal in using

derivatives is to manage risks for all CFC members while allowing each individual member to obtain financing on terms it prefers. CFC's members also qualify for the end-user exception. *See* sections 722(f) of DFA and 201(f) of the Federal Power Act (16 U.S.C. 824(f)) and CFTC's "Further Definitions . . . ," proposal which discuss the specific authority given to CFTC to exempt CFC.

We suggest language such as the following to clarify the application of the affiliate exception:

- **"For purposes of this section, an 'affiliate' of a person includes a nonprofit, tax-exempt cooperative (i) of which the person is a member, and (ii) which is not a depository institution."**
- **"Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."**
- **"For purposes of this section, 'acting on behalf of the person and as an agent' includes: (a) hedging or mitigating a risk that arises from financing provided to the person by an affiliate of that person; or (b) acting for the benefit of that person."**

**3. The exception for financing of a parent company's products should also apply to CFC's activities.** This exception excludes from the definition of "financial entity" entities whose primary business is providing financing, and who are using derivatives to hedge underlying commercial risks related to interest rate and foreign currency exposures, if 90% or more of those risks arise from the finance or lease of products, and if 90% or more of those products are manufactured by the parent company or another subsidiary of the parent.

More than 90% of CFC's business consists of providing financing to its rural electric system member-owners and their related organizations. CFC uses derivatives to hedge interest rate risk related to its financing business. Collectively, CFC's member-owners are analogous to the "parent company" of CFC. While CFC is not a subsidiary of any other entity, it is a cooperative formed and sustained by the collective effort of its members to serve those members by providing them with financing.

CFC's member-owners are in the business of generating and/or distributing electricity. Thus, CFC uses derivatives to hedge interest rate risks which arise from the financing of a product – electricity – which is manufactured and/or distributed by its nonprofit rural electric cooperative member-owners.

We suggest language such as the following regarding the Parent Company Exemption:

- **"For purposes of this section, 'financing that facilitates the purchase or lease of products' shall include financing that facilitates the provision of electric service."**

- **“For purposes of this section, ‘manufacturing’ includes the generation, transmission, and/or distribution of energy, such as electricity.”**
- **“For purposes of this section, ‘parent company’ shall include the members of a nonprofit tax-exempt cooperative that is not a depository institution.”**
- **“Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose.”**

#### **4. CFC should not be considered a “Swap Dealer;” suggested definition of “commercial risk.”**

Our comments on the “Further Definitions of ‘Swap Dealer,’ . . .” (RIN 3038-AD06), “Reopening and Extension of Comment Periods” dated June 3, 2011, and our “Views on Implementation of the Dodd-Frank Act” filed with the CFTC thoroughly explain why CFC should not be considered to be a swap dealer or major swap participant. The “Views on Implementation” document at page 10 explains why CFC qualifies as an “eligible contract participant.”

Thus, we wish to make the point, already made in the above-cited “Views on Implementation” at pages 9 – 12, that CFTC should clarify that the definition of “swap dealer” should exclude productive uses of swaps such as swaps entered into to hedge or mitigate commercial risk.

Also, as we explained in “Views on Implementation,” when CFTC defines the term “commercial risk” (regarding “major swap participant,” a “substantial position in swaps,” and in the end user clearing exemption); that term should mean risks incurred by an entity in connection with its own business including interest rate risk and currency risk.

We suggest that the term “commercial risk” as discussed above and in the CFC’s “Views on Implementation”, include:

- **“any risk incurred by a person or entity in connection with its own business, including (1) interest rate risk; (2) currency risk;”** and other factors CFTC considers appropriate.

#### **5. Definition of “Highly Leveraged Relative to the Amount of Capital It Holds”**

As stated in the CFC “Comment Letter on CFTC/SEC ‘Definitions’ Rulemakings” (re: RIN 3038-AD06) we encourage the CFTC and SEC to consider alternative measures for leverage in addition to the GAAP-based measures proposed. For a nonprofit cooperative like CFC, the adjusted measures we use are much more useful when assessing capital strength. CFC’s metrics and capital structure differ from for-profit banks and savings and loan institutions. Because of its nonprofit cooperative and tax exempt status, CFC is unable to issue equity securities.

Instead of equity securities, CFC issues long-dated subordinated debt (Capital Term Certificates) to its members. The subordinated certificates held by our member owners are available to absorb losses and CFC has offset rights against any amounts owned by the member to CFC

While we understand that GAAP is the normal starting point for evaluating the capital structure of depository institutions, using only GAAP to calculate leverage for an entity like CFC does not give a wholly accurate picture given our structure. We cannot issue common equity to the public as many other types of entities can, and the GAAP-based measures proposed by the CFTC and SEC do not represent an accurate measure of our leverage as a result. Those measures exaggerate CFC's leverage, and under the current thresholds proposed by the CFTC and SEC, CFC would be "highly leveraged."

We do not believe this is a correct categorization, and urge the agencies to consider CFC's atypical structure and its adjusted measures, which acknowledge that certain of the subordinated debt instruments that we issue share characteristics with equity. Our member subordinated certificates have long-dated maturities. CFC has the right to offset the investment in subordinated certificates against any amounts the member-owner owes to CFC. Similar to CFC retained earnings and hybrid investments in other financial institutions; these subordinated certificates are available to absorb losses, thereby protecting capital market investments in CFC.

As we have noted, there is precedent in the bank regulatory context for treating certain debt instruments as regulatory capital. For instance, the capital regulations of the Office of Thrift Supervision (OTS) permit mutual savings associations to include pledged deposits and nonwithdrawable accounts in Tier 1 capital to the extent that such accounts or deposits have no fixed maturity date, cannot be withdrawn at the option of the accountholder, and do not earn interest that carries over to subsequent periods.<sup>8</sup> The banking agencies also currently allow the inclusion of hybrid securities, which possess features of both debt and equity, in Tier 2 capital without limit and in Tier 1 to a limited extent.<sup>9</sup> These securities must meet the following requirements:

- The instrument must be unsecured, subordinated to the claims of depositors and general creditors, and fully paid-up;
- The instrument must not be redeemable at the option of the holder prior to maturity, except with prior regulatory approval;
- The instrument must be available to participate in losses while the issuer is operating as a going concern (in this regard, the instrument must automatically convert to common stock or perpetual preferred stock, if the sum of the retained earnings and capital surplus accounts of the issuer shows a negative balance); and

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<sup>8</sup> 12 CFR § 567.5(a)(1)(iv).

<sup>9</sup> See, e.g., 12 CFR part 3 App. A (National banks may include in Tier 2 capital "Hybrid capital instruments, without limit. Hybrid capital instruments are those instruments that combine certain characteristics of debt and equity, such as perpetual debt"). We note that under rules to be issued pursuant to the Dodd-Frank Act, certain hybrid securities will be phased out of inclusion as Tier 1 capital but will remain eligible for inclusion as Tier 2 capital.

- The instrument must provide the option for the issuer to defer principal and interest payments, if
  - The issuer does not report a net profit for the most recent combined four quarters, and
  - The issuer eliminates cash dividends on its common and preferred stock.

The subordinated debt instruments we include as equity in our adjusted measures share characteristics with such instruments. These instruments are available to absorb losses. They also do not have redemption features that would permit a holder to withdraw funds before maturity, and have long-dated maturities. Further, CFC has the right to offset a member's investment in any of the subordinated instruments issued to members against any amounts the member may owe CFC. This offset right has been utilized by CFC to mitigate loan losses. CFC's member capital securities also have an interest deferral right. We believe the authority for this improvement in the CFTC rules – that will allow you to better assess capital strength – lies in sections 722(f) of DFA and 201(f) of the Federal Power Act (16 U.S.C. 824(f)) and is further discussed in CFTC's "Further Definitions . . . ," regulatory proposal regarding the special conditions "without limitation" regarding rural electric cooperatives and the entities they own.

We suggest language such as the following to clarify the definition of "highly leveraged":

- **"In the case of a nonprofit tax-exempt cooperative that is not a depository institution, 'equity' shall be calculated to include subordinated debt issued by such cooperative and held by the member-owners of such cooperative."**
- **"Each entity that believes it falls into this category shall describe in writing to the CFTC and the SEC the nature of its nonprofit, tax-exempt cooperative structure, and its associated public purpose."**

NOTE: In our filing to CFTC dated June 27, 2011, on "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" (RIN 3038-AC97) we explain why low-risk end users such as CFC should not be subject to margin requirements. On pages 9 – 11 we suggested new criteria for low-risk financial end users.

Also, we have filed recommendations dated June 21, 2011, on credit risk retention and on "Low-Risk End User Counterparties such as CFC" with other entities (Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the SEC, and the Federal Housing Finance Agency). Topics included the creation of a new category of "Rural Electric Utility Loans" that should be subject to discrete underwriting criteria to be considered "qualified assets" and explanations of why low-risk end user counterparties such as CFC should not be subject to margin requirements.